Rates Spark: US CPI should be benign enough for a breather

The UK government's spending review should remind markets of the tight fiscal headroom, providing upward pressure on Gilt yields. In the US, there is also an eye on a tax-cutting package that poses fiscal risks down the line. But we should have a breather nearer term as the CPI data should be tolerable enough. But that will change as the tariffs kick in ahead

Gilt markets will be closely watching Chancellor Reeves' spending review on Wednesday

US inflation should be fine for May, but it's the path further down the pike that is concerning

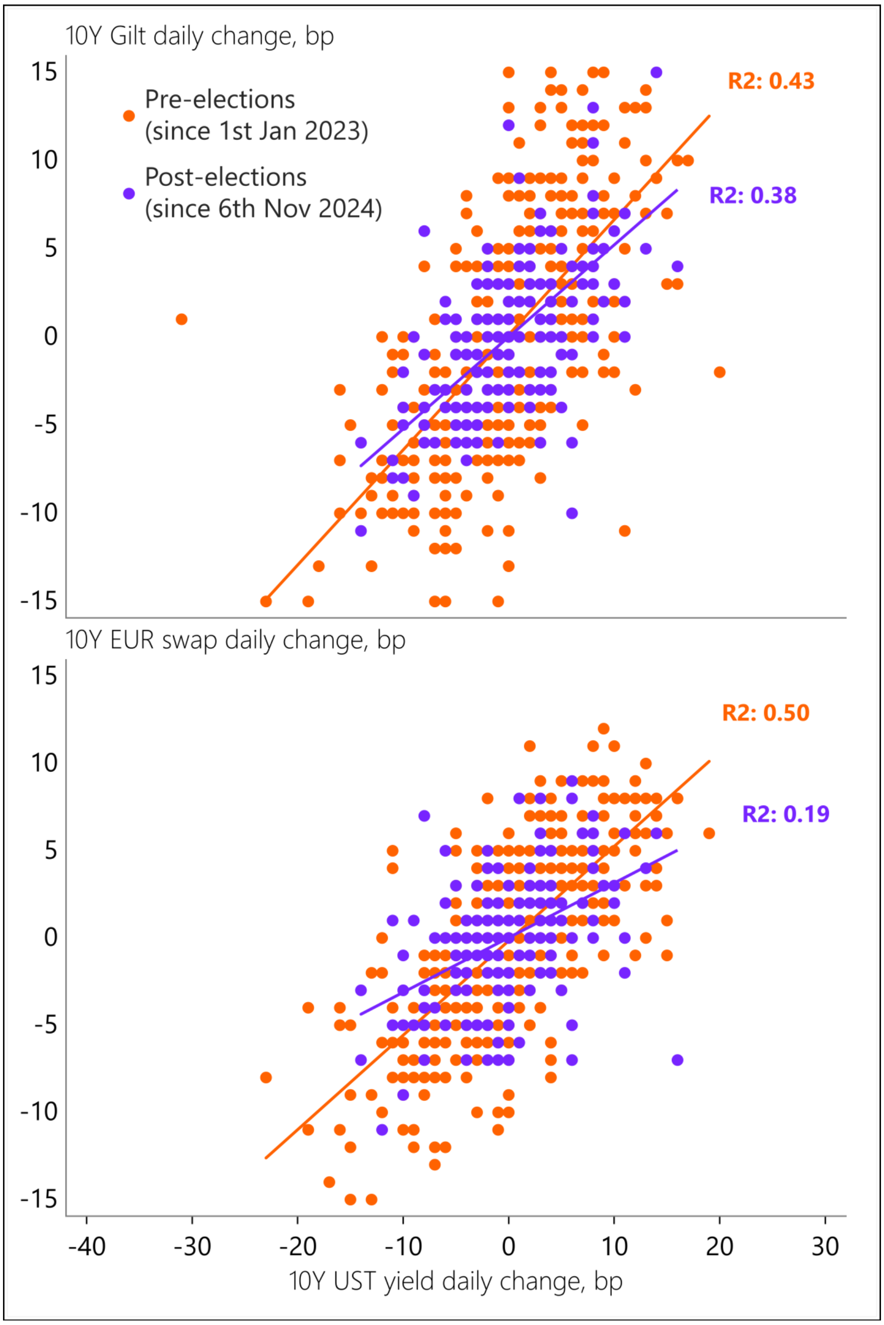
Tuesday's 3yr US auction tailed, which was a disappointment, but the bigger signal will come from Wednesday's 10yr auction (and then Thursday's 30yr auction). Well ahead of the 10yr auction we'll see the CPI release for May. We think there will be 0.2%'s month-on-month, which are fine. If we kept getting those, inflation would tend to be around 2.5%, which is really very fine. Better to be a tad above 2% than a tad below in fact. Normally the bond market would take 0.2% MoM quite well for that reason. However things get more complicated for inflation as we head through subsequent months. The current year-on-year rates range from 2.3% (headline) to 2.8% (core). But these threaten to head for 4% through the third quarter and into the fourth quarter on the tariff impact. If the wider bond market is in agreement on that type of path ahead, it would be tough to get too excited about short-term inflation containment successes.

Upward pressure on Gilt yields from different directions

Gilt markets will be closely watching Chancellor Reeves' spending review on Wednesday. Yesterday's benign wage growth numbers helped the case for a rate cut in August, but fiscal risks continue to keep upward pressure on rates. Markets are nervous about the UK's fiscal situation, as evidenced by the sharp jump in Gilt rates during the budget presentation last October. This week's spending review will highlight the tight fiscal headroom, leaving a bearish taste in rates markets. Until the government moves towards tax increases, which we eventually think it will, the room for longer-dated sterling rates to move lower will be limited.

In contrast to euro rates, sterling rates have remained sensitive to US rate moves. Since the US elections, around 38% of the variance in 10Y Gilt yields can still be explained by moves in USTs. For the 10Y euro swap rate the explainability from USTs fell from 50% before Trump's election to just 18% since. With markets still cautious to price in more Bank of England cuts, the next material move in Gilt yields may therefore very well come from US spillovers. In the US the fiscal story is also a focus point, and thus the room for lower UST yields may be restrained, maintaining upward pressure on Gilt yields.

The correlation between USTs and Gilts remained high after Trump's election



Source: Macrobond

Wednesday's events and market view

US CPI numbers will be the highlight, with consensus expecting a 0.3% month-on-month reading. In the European morning we'll first have the ECB's wage tracker, which should point to a further easing of earnings growth. With markets already firmly attached to an ECB landing zone of 1.75%, this data is unlikely to be a game changer.

In terms of supply we first have the UK with a 10Y Gilt auction and Germany with a 10Y Bund for £3bn. Portugal has scheduled 10Y and 29Y OT auctions for €1.25bn. From the US we have a 10Y Note auction totalling $39bn.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com